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SUPREME COURT, U.S.

No. 98-1

In The

Supreme Court of the United States

October Term, 1997

JAMES A. LONG, JAMES A. KING, RAYMOND KING, JERRY PATE LONG, HOMER L. LONG, KELVIN KING, TRUMAN SMITH, SAM FULTON, DAVID SWEENEY, JIMMY SWEENEY, JAMES SWEENEY, BOB GRAVES, JOHN RATLIFF, DENNIS RATLIFF, and J. P. RATLIFF,

Petitioners,

v.

FIRSTRUST CORPORATION,

Respondent.

Petition For Writ of Certiorari
To The United States Court of Appeals
For the Fifth Circuit

REPLY TO BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether state law may permit further collection of a debt after a financial entity has made a report of cancellation of debt income to the Internal Revenue Service and the debtor, pursuant to federal statutes.

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I. ANY ISSUES PRESENTED BY 26 U.S.C. §6050J HAVE PREVIOUSLY BEEN DETERMINED AGAINST RESPONDENT, AND ARE NOT SUBJECT TO RECONSIDERATION

Respondent asserted in the trial of this cause that the issuance of a 1099A information return would only have been issued on a foreclosure or abandonment of security, or a reason other than to show receipt of income on cancellation of an indebtedness. The District Court sustained Petitioners' objection to any evidence on Respondent's theory, in that Respondent had previously made a formal admission that the 1099 form issued in this case related to the judgment. Further, the Court disallowed any evidence on such theory based upon the Respondent's response to a request for admission that the subject indebtedness was secured only by the individual guaranties.

Respondent's Brief In Opposition merely seeks to reargue the same evidentiary position asserted by Respondent in the trial of this cause, and Respondent was not only prohibited from offering testimony on any theory regarding foreclosure or abandonment of collateral as being the cause of the issuance of the 1099A form, but also the District Court in its Findings of Fact and Conclusions of Law found that the issuance of the 1099A forms "...evidenced their intent to forgive the debt and the issuance of the 1099A forms, from their practice, did indeed evidence their intent to write-off the judgment." This finding by the District Court was amply supported by the evidence offered by Petitioners, including testimony by two expert witnesses who testified that the 1099A form was used by institutions during the relevant time period to show an income transaction based upon discharge of debt.

Respondent's reliance upon 26 U.S.C. 6050J merely attempts to divert attention from the principal statute at issue, being 26 U.S.C. 61(a)(12), and whether the "income from discharge of indebtedness," as that term is used in the federal statute, is determined by state law or federal law.

Petitioners' argument is not bizarre as claimed by Respondent in its Brief In Opposition, but rather presents a clear question of federal statutory preemption. Respondent's analysis in its Brief In Opposition fails to recognize the critical element in this cause regarding cancellation of debt income that is governed by federal law, rather than state law issues concerning a contractual release. Issues of a contractual release, including intent, consideration, mutuality, and accord and satisfaction, and issues regarding gift and windfall, are irrelevant in the context of determining cancellation of debt income.

II. PETITIONERS HAVE NOT WAIVED THEIR RIGHT TO CLAIM FEDERAL STATUTORY PREEMPTION, IN THAT SUCH ISSUE HAS BEEN RAISED IN THE LOWER COURT.

Petitioners have consistently plead and argued throughout this entire case that the federal statutes regarding the determination of income from discharge of indebtedness, and the corollary statutes and regulations which govern information returns, control this dispute. Further, Petitioners have consistently argued that the state law asserted by Respondent, including issues of a contractual release, gift, and windfall, are not determinative of this dispute and, in fact, are irrelevant in the context of determining cancellation of debt income. The statutes have included 26 U.S.C. § 61(a)(12); 26 U.S.C. § 108, and 26 U.S.C. § 6041, et seq. Petitioners relied

on these statutes in the District Court, and the District Court found that the discharge of the debt, as evidenced by the issuance of the 1099A forms and the write-off of the debt on the books of the institution, created a taxable event and that the judgment debtors were recipients of income based upon the discharge of the indebtedness from the judgment creditor. It is obvious that the District Court gave controlling effect to the federal statutes with regard to its findings that there was a "discharge of the debt," "taxable event" and "recipient of income."

Further, the Fifth Circuit's characterization of the dispute as "...the legal significance of IRS forms 1099A..." necessarily encompasses the federal statutes which determine the requirements of the 1099 forms, and the federal statutes which would relate to cancellation of debt income. The Fifth Circuit fails to address these federal statutes, but the District Court findings and the characterization of the dispute by the Fifth Circuit show that the controlling or preemptive effect of the federal statutes had been properly raised. Federal questions raised in the lower court, even if not addressed by the lower court, may properly be considered by the United States Supreme Court. *Lynk v. La Porte Superior Court No. 2*, 789 F.2d 554 (7th Cir. 1986).

Additionally, in order to show that the specific issue involving the controlling effect of the federal statutes was properly before the Fifth Circuit, excerpts are included herein from Petitioners' Brief for Appellees and Cross-Appellants (Appendix A) and Petitioners' Appellees Petition for Rehearing (Appendix B). Respondent has agreed that this specific issue was raised in the Fifth Circuit by Petitioners' Motion for Stay of Mandate Pending Petition for Writ of Certiorari.

Respondent has not contended that the issue was not properly raised in Petitioners' Petition for Writ of Certiorari, and, Petitioners have duly complied with Supreme Court Rule 14(1)(a). This Court has granted certiorari when the question of federal statutory preemption was not raised by the petition, but had been presented in an amicus brief. *Capital Cities Cable, Inc., v. Crisp*, 467 U.S. 691, 81 L.Ed.2d. 580 (1984). Petitioners submit that the issue presented in the Petition for Writ of Certiorari, and duly argued and presented in the lower courts, presents a proper question to submit to the Supreme Court.

CONCLUSION

This case presents issues of importance to the administration of federal law, and Petitioners respectfully request this that the Supreme Court grant Certiorari to review these issues.

Respectfully submitted,

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APPENDIX A

ARGUMENT AND AUTHORITIES

Issue No. 1:

Whether there is any evidence or legally sufficient evidence to support the findings that issuance of the 1099A forms by the RTC evidenced their intent to forgive the debt and to write off the judgment debt, the write off of the judgment debt and issuance of the 1099A forms was inconsistent with the further enforcement of the judgment, the judgment debt was forgiven, and the banking industry generally and RTC particularly intended to forgive debt when they issued 1099A forms to borrowers or judgment debtors, and resulting judgment that the Resolution Trust Corporation released the judgment against the male plaintiffs so that Firstrust Corporation cannot now collect from the male plaintiffs on the judgment.

Standard of Review: The standard of review is

"clearly erroneous" for the findings of fact and "de novo" for conclusions of law.

Plaintiffs' theory on their claim for declaratory judgment relief is based upon actions of New MeraBank Texas, FSB, a prior owner and holder of the subject judgment. It was undisputed and the District Court found that the institution caused to be issued a form 1099A to each of the male Plaintiffs for the tax year 1991. (Record Excerpts, Item D). Defendant admitted that the 1099 forms had been issued in regard to the subject judgment. (R. 4, p. 1068; Plaintiffs' Exhibit No. 289). The District Court found that a write off of the judgment debt and the issuance of the 1099 forms was inconsistent with the further enforcement of the judgment, and that the judgment debt had been forgiven. (Record Excerpts, Item D). Based upon these findings, the District Court found that the institution released the judgments when they issued the 1099 forms, in accordance with the industry

practice and in accordance with the practice of institutions under government supervision. (Record Excerpts, Item D). Further, the District Court concluded that the judgment in this case was not subject to continued enforcement, and that the satisfaction of such judgment would bar any assignee from enforcement the judgment. (Record Excerpts, Item D).

The Plaintiffs' theory in this case involves the concept of cancellation of debt income. A taxpayer is generally treated as realizing taxable income if a debt he owes is forgiven. Pursuant to 26 U.S.C. § 61(a)(12), a taxpayer must include in gross income a discharge of indebtedness. See generally, *Mertens Law of Federal Income Taxation*, Vol. 2, Chap. 12, § 11.16, et seq.; 47A C.J.S., *Internal Revenue*, § 68; 33A Am.Jur.2d, *Federal Taxation*, ¶ 12850. This general rule was first espoused in *U.S. v. Kirby Lumber Co.*, 284, U.S. 1, 76 L.Ed. 131, 52 S.Ct. 4 (1931). See also, *Colonial Sav. Assn. and Subsidiaries v. C. I. R.*, 854 F.2d 1001 (7th Cir.

1988), reh. denied, cert. denied, 109 S. Ct. 1556, 489 U.S. 1090, 103 L.Ed. 2d 859.

Under the provisions of the Internal Revenue Code, every person made liable for any tax imposed by the Code must make such returns and comply with rules and regulations as may be prescribed. 26 U.S.C. §§ 6001, 6011. The Code makes provision for filing information returns if there has been a taxable event which may result in reportable income. 26 U.S.C. § 6031, et. seq. These specific provisions regarding the issuance of 1099 forms are contained in Subpart B in Subtitle F, Chapter 61, of the Internal Revenue Code. In this subpart, the various Code sections specify when information returns must be filed to report to the Internal Revenue Service and the individual involved that payments have been made to the individual or other transactions have been entered into which give rise to income. The 1099 forms are the information returns used to report these transactions.

Effective after 1993, the provisions of 26 U.S.C. § 6050P specifically relate to discharge of debt by certain financial institutions. Prior to that time there existed some confusion with regard to the proper information return form in which to make the report of cancellation of debt. (R. 7, pp. 269, 273, 274, 286). Regardless of the suffix on the 1099 form, it is clear that at the time the 1099A form was issued in this case, there was recognition that a taxable gain existed for cancellation of debt. *Malone v. United States*, 326 F.Supp. 106 (N.D. Miss. 1971) affirm. 455 F.2d 502 (5th Cir. 1972).

A further statutory reference that is relevant to this dispute is 26 U.S.C. § 108. Defendant has contended that if the report of cancellation of debt income to the Plaintiffs did not create an actual tax liability, then the Plaintiffs would not be entitled to claim relief from the judgment. Section 108 of Title 26 provides certain situations in which income from discharge of indebtedness would not be included in the

taxpayer's report of gross income. It is submitted that if Defendant intended to carry his burden, he would first have to show that the taxpayers were not excluded from showing the reported income as gross income.

Based upon the circumstances surrounding the write-off and issuance of the 1099 forms to the male Plaintiffs, the conclusion was formed, and well-supported by the evidence in this case, that there had been a discharge of the indebtedness represented by the judgment. Any further attempt to seek enforcement of the judgment, either by the original owner and holder of the judgment, or by its assignee(s), would be inconsistent with the prior actions. Defendant's own expert, Michael D. Pierce, recognized that continued collection efforts on the judgment would be inconsistent with previous actions showing cancellation of debt income to the judgment defendant. (R. 9, p. 147). Defendant did not dispute that continued collection efforts on

the judgment would be inconsistent with actions showing cancellation of debt income. Even though not directly addressing the 1099 issue, there is case authority which recognizes that the imposition of a taxable gain on discharge of debt is inconsistent with continued litigation on the underlying debt. *Exchange Security Bank v. United States*, 345 F.Supp. 486 (N.D. Ala. 1972), rev'd on other grounds, 492 F.2d 1096 (5th Cir. 1974).

APPENDIX B

ARGUMENT AND AUTHORITIES

Issue No. 1:

Whether the Appellate Court has erred in failing to give proper legal effect to the issuance of a 1099 tax form.

The decision of this Appellate Court is in direct conflict with an existing Federal statute, and the implementation of this decision will create enormous uncertainty between lenders/creditors,debtors/taxpayers, and the Internal Revenue Service. The finding of this Court is that the issuance of a 1099 tax form, based upon a decision to forgive a debt, does not cause a discharge of the debt. The Court does not make any apparent distinction between a judgment debt, and any other debt arising by note or contract. As described in the Brief for Appellees, 26 U.S.C. § 6050P became effective in 1993 in order to clarify the requirement for the issuance of a 1099 on discharge of indebtedness.

Previously, there had been some confusion regarding the appropriate 1099 to issue, but the testimony in the present case was that the 1099A form had been used by institutions prior to the passage of Sec. 6050P. The statute now provides that any applicable financial entity that discharges (in whole or in part) the indebtedness of any person during any calendar year is required to file a return setting fourth specific information. The code makes provision for filing information returns if there has been a taxable event which may result in reportable income. 26 U.S.C. § 6031, et. seq. The specific provisions regarding the issuance of 1099 forms are contained in Subpart B in Subtitle F, Chapter 61, of the Internal Revenue Code. The return is required whether or not the debtor is subject to tax on the discharge, and the financial entity is not required to determine whether the discharge is excludable from the reported income. 34 Am.Jur.2d, *Federal Taxation*, ¶ 60231 (1996). It is significant that this

information return is a legal requirement of the issuing entity, and it has previously been discussed that the receipt of the 1099 tax form on discharge of indebtedness is a taxable event, constituting "cancellation of debt income." 26 U.S.C. § 61(a)(12). The reported income may be excludable from the taxpayer's return based upon varying circumstances. 26 U.S.C. § 108. This Appellate Court has created an incongruous situation which would allow a financial entity to cause the issuance of a 1099 report of income to a borrower, which creates a potential tax liability to the borrower/taxpayer, and leaves the taxpayer legally liable on the full debt. This Court has found that this is a proper result even though the financial entity has made a conscious and deliberate decision to discharge the indebtedness. In other words, the financial entity can "cancel the debt," and potentially receive a tax benefit (loss), but thereafter collect the debt as if it was not "canceled." The borrower/taxpayer

should certainly be entitled to challenge, as Appellees did in this case, that they have been reported to the Internal Revenue Service as receiving cancellation of debt income, on which a tax liability may arise, and yet they remain liable as if the debt had not been canceled by the financial entity. Certainly, the borrow/taxpayer should be able to challenge the financial entity as to any right it had to cancel the debt, report income to the borrower, and yet collect or assign for collection the underlying debt. This result seems intolerable under the current requirements of Sec. 6050P, and intolerable prior to passage of Sec. 6050P, when the institution was utilizing the 1099A form to report cancellation of debt income to the Internal Revenue Service.

Further aggravating this situation would be the conflicts and potential challenges arising from whether the Internal Revenue Service can compel a report of cancellation of debt income on the taxpayer's return and still leave the

taxpayer subject to liability for the full debt. The consequences of this Appellate Court's decision are enormous.